initial comments, long-term Total Factor Productivity is the only appropriate measure of LEC productivity, not LEC earnings. The use of long term productivity results appropriately reflects those elements that lead to sustained effects of productivity growth, but weeds out fluctuations that merely affect the achieved level of productivity at a given point in time.[62] This allows the average price of the firm to move with the long term productivity potential, contributing to the long term stability of the price cap plan.

(4) Incentive Regulation Yields an Expectation of Increased Profits --

Most important, even if LEC earnings have risen somewhat under price caps, this should not be a surprise -- it is supposed to happen![63] Given that the increase in LEC profits has also been accompanied by a significant decline in interstate access rates (in spite of an overall inflation in the economy of 11.6%),[64] as well as LEC pricing that has been consistently at or below applicable PCIs, increased LEC earnings indicate only that price cap incentives are in part functioning as the Commission intended. As Professor Harris observes, to increase the productivity offset now would "strip away the very incentives that price caps were intended to create."[65]

The FCC should lower the LEC productivity offset in accordance with the Christensen Study, which adding in the CPD comes to 2.2%.[66] Moreover the

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62/ Thus, for example, although a one-time cost reduction achieved through downsizing may cause a productivity gain in a particular period, the productivity offset should not be revised because the incremental gain in productivity achieved as an immediate result of the force reduction does not produce additional or incremental gain in subsequent years.

63/ As the Notice observes, the driving incentive under price caps is profitability: "The LECs are rewarded with higher profits if they achieve productivity growth above the target, and are penalized with lower profits if they fall short." Notice at 20, ¶ 45.

64/ Overall, LEC interstate access rates are currently $1.5 billion lower than at the start of price caps, with some $373 million attributable to LEC pricing below the cap. Id. at 9, ¶ 25.

65/ Harris Reply Report at 28.

66/ Earlier this month, the Pennsylvania PUC, discounting input price differential arguments of parties such as Ad Hoc, adopted a productivity offset of 2.93%. see Pennsylvania Public appropriateness of a reduction in the LEC productivity offset is reinforced by the likelihood that as competition continues to emerge rapidly in the local exchange market the aggregate productivity growth of the price cap LECs in the coming years will be slower than the historical industry average reflected in the current price cap plan.[67]

C. Sharing Should Be Eliminated

In the initial comment round, BellSouth and many others -- LEC and non-LEC alike -- urged the Commission to eliminate the sharing and low-end adjustment mechanisms currently embedded in the LEC price cap plan.[68] Some non-LEC parties advocate the retention of sharing,[69] and AT&T and MCI go even farther to urge the retention of sharing combined with the elimination of the low end adjustment mechanism.[70]

It is in dealing with the sharing issue that agendas of certain non-LEC competitors become most clear, because they provide so little in the way of reasoned analysis or justification for retaining a mechanism that is so fundamentally at odds with the theory of price caps. AT&T, for example, offers only a conclusory statement that sharing is an "integral component" of the LEC price cap plan which ensures "reasonable access rates" to LEC customers, but does not and cannot offer any convincing theoretical or empirical explanation as to why it should be retained. (AT&T, of course, remains unhindered by any sharing mechanisms in its own price cap plan.)

Utility Commission, Press Release (June 2, 1994). Moreover, as NERA shows, there is no statistically significant difference in input price growth between the telephone industry and the U.S. economy generally. NERA Reply Report at 23. Therefore, Ad Hoc's suggested "input price differential" adjustment must be rejected.

67/ See Comments of BellSouth at 34-38.

68/ See, e.g., Comments of CCIA at 7-8; Comments of Citizens for a Sound Economic Foundation at 5-8; Comments of Sprint at 13; Comments of USTA at 45-52.

69/ See, e.g., Comments of Ad Hoc at 24; Initial Comments of International Communications Association (ICA) at 14.

70/ See Comments of AT&T at 29-30; Comments of MCI at 31-32.

Similarly, MCI cites the fact that "market risk and uncertainty continue to exist" as a reason to retain sharing.[71] But this reason supports the elimination of sharing, not its retention. As Dr. Darby has pointed out, a primary flaw of an earnings sharing mechanism is precisely the fact that it "leads to increased risk and will lead carriers to forego investment opportunities that would contribute to the public interest and that they otherwise would undertake":

> The current sharing provisions reduce the expected return from risky investments and further dampen investment incentives. The greater the uncertainty of the investment outcome, the greater the investment disincentive effects of the current sharing arrangement. The disincentive effect is especially troublesome, given the higher risk certain to be associated with future investments in the local exchange network.[72]

MCI's position is inherently self-contradictory. On the one hand it argues that the presence of even more market risk and uncertainty argues for sharing's retention. On the other hand, it argues that although sharing should be retained, the low end adjustment mechanism should be eliminated -- knowing that the elimination of "the downside protection for earnings without providing upside opportunities would tend to discourage risk taking and investment" by LECs in the public switched network.[73] MCI's position should be rejected.

The sharing and low end adjustment mechanisms are rate-of-return based anachronisms that perpetuate the distortion of price cap incentives.[74] They introduce the

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71/ Comments of MCI at 31.

72/ Darby Report at 21.

73/ Id. at 21.

74/ As Dr. Darby observes:

> The particular form of the sharing mechanism determines a) the earnings level at which the disincentives will be realized and b) the strength of the disincentives, as they vary with the proportions to be shared. Adjusting the sharing mechanism cannot eliminate the disincentives, but can only vary their strength and trigger points. Thus, sharing undercuts the very fundamental goal of price caps, which is to increase efficiency incentives.

very types of inefficiency that the price cap plan was designed to eliminate. And in the big picture, they simply have no place in a price cap plan that must facilitate a regulatory transition to effective competition, and which has among its objectives the promotion of infrastructure development, the stimulation of economic growth, the stimulation of enhanced productivity, and the facilitation of rapid new service introduction and technology deployment.[75]

None of the parties that advocate the retention of an earnings sharing mechanism acknowledge the perverse effect that it has on price cap incentives. Indeed, parties like Ad Hoc either blindly or purposefully ignore the fact that a system of price regulation "fundamentally changes the character of the contract between the regulator and the regulated":

> Under price regulation, the regulator no longer assures an opportunity for a return of investment; it demands only that prices not be raised above a certain rate, as determined by the price cap formula. In return, the regulated firm agrees to take the risk of making continued investments with no assurance that it will be able to earn its cost of capital on those investments.
>
> The goal of regulation is to control prices for those services that are not competitive. Under rate of return regulation, controlling earnings was the indirect means of controlling prices. Controlling earnings was not, is not, and should not be an end in itself.[76]

Price regulation achieves the principal goal of regulation by limiting prices directly for basic services. The parties that advocate the retention of sharing, however, plainly are not interested in achieving regulatory goals. Their interest is in hampering LEC growth and incentives wherever and however possible. The Commission should reject these attempts and reform the LEC plan consistent with the theoretical and real benefits of pure price regulation.

Darby Report at 20.

75/ See Comments of USTA at 21-23, 45-52.

76/ Harris Report at 21.

Baseline Issue 5: Common Line Formula

In responding to the Commission's inquiry regarding whether the current common line formula should be modified, BellSouth emphasized the relationship between the common line formula and the productivity factor. In this proceeding, BellSouth and other LECs have advocated that the Commission adopt a measure of total factor productivity as the productivity offset. If the Commission adopts such a measure, then continuation of the current balanced 50/50 formula, which includes an adjustment for demand growth, would double count the productivity gains already reflected in the measure of total factor productivity. If the Commission nevertheless chooses to retain the balanced formula, then it will have to adjust the total factor productivity offset downward to prevent this double counting.[77]

Some parties urge the Commission to adopt a per line common line formula.[78] They attempt to justify this change by arguing that all demand growth is attributable to interexchange carriers.

The debate over who is responsible for demand growth -- LEC or IXC -- is not new. In the initial LEC price cap proceeding, the Commission did not subscribe to interexchange carrier arguments that they are solely responsible for demand stimulation. Nothing original has been offered in this proceeding to warrant Commission adoption of a different view, i.e., that growth is the exclusive province of interexchange carriers.

In any event, however, the total factor productivity offset proposed by the LECs in this proceeding fully reflects the productivity gains associated with stimulated growth. Thus, access customers already benefit from stimulation through the price cap plan's productivity offset. To move to a per line formula in effect denies the LEC the ability

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[77] See Comments of BellSouth at 52-54.

[78] See, e.g., Comments of AT&T at 26-27; Comments of MCI at 35-38.

to realize productivity gains associated with demand growth and thus penalizes the LEC.[79] Indeed, recognizing the additional productivity hurdle a per line formula would impose, both MCI and AT&T concede that the productivity factor would have to be adjusted downward. For example, AT&T suggests that the productivity offset would have to be reduced by .8 percent.[80] Thus, if the Commission were inclined to move to a per line common line formula, the productivity offset would have to be revised.

Baseline Issue 6: Exogenous Cost Changes

In the Notice, the Commission proposed to narrow the list of cost changes afforded exogenous treatment contained to Section 61.45(d)(1) of the Rules, and to limit eligibility for exogenous treatment to "economic cost changes."[81] In its Comments, BellSouth gave specific recommendations for changes in Section 61.45(d)(1).[82] BellSouth also pointed out that the initial rates of price cap LECs were set based on accounting costs that varied in some respects from economic costs. GAAP changes that bring accounting costs more into line with economic costs therefore must be reflected in the price cap indices if the LECs are to be afforded an opportunity to recover the economic costs not previously recognized by the Commission. Other commenting parties made the same observation.[83]

BellSouth also pointed out that LEC earnings are measured according to accounting costs. The accounting costs recognized by the Commission significantly

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79/ If the issue is to be decided on the basis of the best way for end user consumers to realize the benefit of common line reductions, then the Commission should consider the approach suggested by Southwestern Bell which, among other things, would enable LECs to develop common line recovery mechanisms that would enable LECs to pass price changes on directly to end users. See Comments of Southwestern Bell at 47-48.

80/ See Comments of AT&T at 26 and Appendix B.

81/ Notice at 26, p. 64.

82/ Comments of BellSouth at 55-56.

83/ See, e.g., Comments of Rochester at 21-22; Comments of Sprint at 19-19; Comments of USTA at 86. See also Harris Reply Report at 26.

understate the true economic costs incurred by the LECs both by requiring that the LECs record unreasonably low depreciation expense and by nonrecognition of significant amounts of prudently invested capital in the rate base.[84] BellSouth's reported earnings are therefore artificially inflated. If BellSouth's recommendation to eliminate the sharing and lower formula adjustment mechanisms is adopted, this distortion will be of less importance. If, however, these mechanisms are retained, it is imperative that the Commission continue to recognize changes in accounting costs as exogenous.

MCI's position on exogenous costs is so internally inconsistent as to be unfathomable. MCI starts with a clear statement that the category of costs that should be given exogenous treatment should be narrowed "to include only specific, Commission-ordered cost changes that shift costs between the interstate and intrastate jurisdictions or between regulated and non-regulated operations." All other costs would be considered endogenous absent a waiver.[85] From this starting point, MCI then proceeds to list a series of cost reductions for which it seeks exogenous treatment because they reduce "interstate plant",[86] "interstate costs"[87] or "interstate revenue requirements."[88] Included under these rationale are sales of exchanges by price cap LECs and expiration of the amortization of Equal access and Network Reconfiguration ("EANR") costs.[89]

MCI either does not recognize or simply ignores the blatant inconsistency in its position with regard to exogenous costs. Neither the sale of exchanges nor the amortization of EANR costs results from shifts of costs between jurisdictions or between

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84/ Comments of BellSouth at 40-43.

85/ Comments of MCI at 45.

86/ Id. at 47.

87/ Id. at 48.

88/ Id.

89/ Id. at 47-48.

regulated and nonregulated operations. The fact that a cost change affects the interstate "rate base" or "revenue requirement" does not meet either the existing test for exogenous treatment or the standard proposed by MCI. Indeed, to treat as exogenous any cost change that affects the interstate "rate base" or "revenue requirement" is nothing less than a return to full cost of service regulation. MCI's proposed additions to the categories of exogenous costs should be rejected.

While not proposing a new standard to evaluate exogenous costs, AT&T also requests that the Commission require the LECs to treat as exogenous the end of the amortization of LEC EANR costs and the sale of high cost exchanges by price cap LECs.[90] AT&T utterly fails to justify its request under the existing exogenous cost standard. With regard to EANR costs, the Commission has previously rejected exogenous treatment of these costs both because they were not totally beyond the control of the LECs, and because the Commission could not adequately segregate these costs from switched access costs.[91] With respect to the sale of high cost exchanges, such sales are clearly within the control of carrier management, and thus do not meet the threshold test for exogenous treatment. The sale of high cost exchanges is a cost reduction move no different in principal from the reduction of labor costs or material costs, both of which are treated endogenously. AT&T offers no rationale to justify treating these cost reductions as exogenous when all other cost changes that result from management initiatives receive endogenous treatment.

BellSouth sympathizes with the concern expressed by the Commission and other parties that the existing exogenous cost rules are unduly complex -- in administration if not in theory. All participants in the OPEBs proceeding[92] shared the frustration of

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[90] See Comments of AT&T at 45.

[91] LEC Price Cap Order, 5 FCC Rcd at 6808.

[92] Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other than Pensions," 8 FCC Rcd 1024 (1993).

attempting to identify and measure the disproportionate impact of an accounting rule change on the LECs vis-a-vis the rest of the economy. The application of the exogenous costs rules in that proceeding put the price cap LECs at a distinct disadvantage vis-a-vis cost-of-service LECs and AT&T.[93] The Commission should do all that it can to avoid a similar result here, and should adopt BellSouth's proposals to update the exogenous cost rules.

Baseline Issue 8: Rates and Regulations for New Services

In the Notice the Commission made clear that one of the "primary objectives in adopting the LEC price cap rules was to provide carriers with incentives to become more innovative in the development and introduction of new, high quality services."[94] Given the importance of new service treatment to the achievement of price cap policy goals, the Commission expressed legitimate concern that the rules governing new services may impose unnecessary impediments to the introduction of new services.[95]

93/ Despite AT&T's opposition to the recovery of OPEB costs by the price cap LECs, and the Commission's subsequent investigation of the LEC tariff filings designed to recover those costs, AT&T included the full amount of its OPEB costs as exogenous (approximately $240 million for its price capped services). Recently, AT&T has treated as exogenous an additional $231.11 million as a result of its adoption of SFAS-112. AT&T has also unilaterally included $3.23 million for regulatory fees which the Commission has held can be included as exogenous costs only after a waiver has been obtained. See Letter from M.F. Del Casino, AT&T's Administrator - Rates and Tariffs, to William F. Caton, Acting Secretary, Federal Communications Commission dated May 17, 1994, Attachment, pages 7-10. The Commission's disparate treatment of AT&T and the price cap LECs with regard to these costs is unexplained and unjustified.

94/ Notice at ¶ 73.

95/ Even ostensibly modest regulatory delays in the introduction of a new services may have chilling financial effects on carrier incentives to invest in new technologies and to innovate new services. After examining the impact of regulatory delay in the introduction of an illustrative new service in the context of a standard capital budgeting model, Dr. Darby concludes that a one year delay could result in a reduction of more than twenty percent in the expected economic value of a new service innovation: ". . . regulatory delay reduces the expected value of a service innovation dramatically; it reduces the rate of new service introduction and increases risk to incumbents; and, it could very well lead to decisions not introduce services that otherwise would have been made available." Darby Report at 22 n.41.

Price cap LECs uniformly concur that the Commission's current treatment of new services operates to inhibit rather than to encourage new service introduction. From BellSouth's perspective, the problem can be characterized as one of over-regulation.

Not surprisingly, the non-LEC parties do not share the LECs' concerns. Some parties, like MCI, believe the Commission should maintain the current support requirements. Others contend that the new service rules are too lenient.[96] They urge the Commission to establish mechanisms to curtail further even the limited pricing flexibility that the LECs have under the current rules.[97]

Most of these comments suffer from the same fundamental flaw. Either implicitly or explicitly, their arguments presume that there is a cost which equates to a price for each and every new service. If this proceeding does nothing else, it must dispel the myth that cost-based means that price equals cost. As BellSouth earlier observed, the telecommunications market is characterized by a cost structure such that if price is set to equal marginal (incremental) cost, the revenues generated by such prices would be inadequate to cover total costs. To presume that there is some formulaic mechanism -- e.g., uniform loadings, ceiling tests or indexing -- to achieve the "cost-based" rate has no foundation in economic theory. To the contrary, the ritualistic recitation of the "cost-based" mantra misses the point. To establish a set of economically efficient prices, demand considerations must be taken into account.[98]

In a market environment where new services, for the most part, are discretionary, and therefore, the purchase of the services is optional, an approach to setting

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96/ See Comments of MCI at 56.

97/ See, e.g., Comments of MFS at 3-4, 26-27; Comments of Wiltel at 30-33.

98/ In the past, seizing upon the term "cost-based" as the weapon of choice was a means of improving the odds of winning the regulatory battle. Under price regulation the Commission's efforts are directed at making the public the winners, not the individual regulatory competitors.

prices which fails to adequately take into account demand runs the substantial risk that the prices so established are unattainable in the marketplace. With competition, the likelihood of mispricing service increases.

In the Notice, the Commission perceived a tension between its goal of encouraging innovation and its oversight responsibilities to secure just and reasonable rates. In suggesting retention of the current new service constraints or in proposing additional ones, commenters express a variety of concerns, but all of the limitations that are advocated by these parties are more restrictive than is necessary to address the concerns expressed. Hence, the balance the Commission seeks to strike is lost.

For example, concerns regarding anticompetitive pricing or cross-subsidy do not require elaborate regulatory schemes to address. The issue involves the appropriate price floor. BellSouth, in its comments, suggested that new service filings be accompanied by a showing that the proposed price equals or exceeds long run incremental cost. Even MCI acknowledges that any new service price that covers the direct cost of the new service is not being subsidized by existing services.[99]

Some parties also attempt to burden the LECs with a host of additional requirements. MFS, for example, believes that a new service should be brought into the price cap index immediately and be subject to the cost consistency test. BellSouth has

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[99] Comments of MCI at 54. MCI and others urge the Commission to define direct cost as total service long run incremental Cost (TSLRIC). Conceptually, BellSouth agrees that TSLRIC is an appropriate price floor for new services. TSLRIC would include a cost element caused by the introduction of the new service but is not attributable to any particular rate element. In other words, while it is a service specific cost, it is a shared cost for the service as a whole and should not be allocated to rate elements. MCI in other proceedings has used the term TSLRIC to include joint and common costs which it claims should be recovered by establishing building blocks. Under MCI's approach, joint costs which support multiple services would become a building block which in turn would have to be used with other building blocks to assemble a new service. In BellSouth's view, MCI's building block approach rapidly deteriorates into an arbitrary cost allocation scheme, without economic foundation or justification.

already identified the infirmities associated with MFS's cost consistency test.[100] Moreover, the list of regulatory proscriptions advocated by MFS goes far beyond any reasonable solution to address legitimate concerns of the Commission.

An equally inappropriate approach is suggested by ICA, which proposes a "price linking" for new services which would require the calculation of a shadow price index based on forecasted demand.[101] The shadow index would be updated every quarter for actual demand. If the forecasted demand was incorrect, the price cap would be adjusted. This convoluted system is proposed because ICA perceives that LECs have the incentive to bring new services into the price cap index at low rates. ICA believes that by bringing the new services into the index at low rates, LECs immediately obtain additional pricing flexibility.

ICA simply misapprehends the operation of price caps. When a new service is brought into the index, there is no change in the API. Instead, the revenue weights underlying the API include the new service. It is from this point that all price changes are measured for being within band and cap limitations. Put another way, the LEC has no more or less pricing flexibility after it brings a new service into the price index than it had before it brought the service into the index. Certainly, such an outcome was intended when the commission first adopted the price cap plan. ICA's proposal attempts to fix something that is not broken.

Lastly, the Commission must reject the notion that LECs use whatever new service pricing flexibility that may be available to thwart competition by mispricing interconnection services.[102] Time and again, reference is made to expanded

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[100] See supra at 12-14.

[101] Comments of ICA at 21.

[102] See Comments of ICA at 4-5; Comments of MFS at 26; Comments of Teleport at 25-26.

interconnection. In the first instance, expanded interconnection has been excluded from price cap regulation. Thus, the LECs enjoy no pricing flexibility whatsoever.[103/]

Absent from those comments that call for new limitations on new services is any consideration of the balance of competing interests that the Commission seeks to achieve in its price cap plan. BellSouth believes that this balance can best be achieved by a dual approach to new services. The vast majority of new services will be discretionary. For these services, the objective of the price cap rules should be to stimulate their introduction and facilitate their effectiveness. BellSouth's proposal would establish a price floor test (based on long run incremental costs) for these services. New services meeting this test would be presumed valid at the conclusion of a 30-day notice period.[104/] In this way the new service rules would encourage LECs to introduce innovative services that will increase consumer choices and improve the overall quality of services.

At the same time, BellSouth recognizes that it is appropriate for the Commission to scrutinize certain services more closely. To address this need, BellSouth suggested that the Commission create a special, predetermined and narrowly-tailored class of new services that are exceptions to the general rule. For these services, the LEC would have the additional burden of demonstrating that the filed rates are just and reasonable.

103/ Parties such as ICA and MFS refer to the ongoing investigation of the expanded interconnection rates and argue that the investigations evidence that LEC mispricing of interconnection arrangements. See Comments of ICA at 4; Comments of MFS at 2-3. To the contrary, BellSouth has shown that the method it used to establish its interconnection rates is reasonable. Moreover, the record evidence shows that the overhead loadings borne by expanded interconnection services compare favorably to the loadings reflected in the prices of BellSouth's high capacity offerings.

104/ An approach that presumes the validity of a new service still enables the Commission to issue accounting orders and conduct tariff investigations. Nonetheless, it also recognizes that considerable public interest benefits can accrue if new services can be implemented more quickly than is the current practice.

BellSouth's proposal avoids the trap of overregulation. Where the marketplace provides an adequate constraint, as in the case of discretionary services, the Commission need not be proactive. Its proper role in such a scenario is one of oversight. For those new services that would come within the narrowly tailored exception, the Commission would pursue the more traditional regulatory approach through the tariff review process. The balance that BellSouth's recommendation provides would enable the Commission to be certain that its approach to new services is one which is truly complementary to incentive regulation.

III. TRANSITION ISSUES

Price cap regulation represents a transition mechanism toward a competitive interstate access market. With increasing competition, that regulation should be adjusted accordingly.[105] Because regulation seeks to replicate the competitive market, i.e., to provide the same incentives and discipline that market forces alone typically provide in fully competitive situations, the Commission must include in its regulatory framework the means to disengage from regulation when market forces have become adequate to provide the necessary checks on output and prices.

In response to the transition issues set forth in the Notice, a number of parties suggest, implicitly or explicitly, that it is premature for the Commission to consider streamlined regulation for interstate access services.[106] Collectively, these parties fabricate a scenario which characterizes competition as a "future thing" and curiously call for increasing regulation coincident with increasing competition. This through-the-looking glass paradigm is supposedly supported by the notion that there is little competition for local

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[105] See Harris Reply Report at 3-4 ("When changes are occurring rapidly and at an accelerating rate, policies need to aim at a moving target . . . . Good policies -- whether corporate or public -- utterly depend on their ability to adapt to the future as events and conditions unfold.").

[106] See, e.g., Comments of AT&T at 21; Comments of MFS at 39-40; Comments of Sprint at 22; Comments of Time Warner at 6.

exchange service, and yields the false conclusion that the Commission accordingly must closely regulate interstate access services.

The record in this proceeding depicts a local exchange environment in which competition is expanding daily at an astounding rate, in a manner which utterly belies the static marketplace characterization and torpid pace of emerging competition that non-LECs would have the Commission accept as the baseline for considering price cap reform. BellSouth, for example, submitted considerable information regarding the status of exchange and access competition detailing the numerous advances that competitors have made in the BellSouth region and the considerable competitive pressures that BellSouth is experiencing in a number of markets.[107] More generally, Professor Harris prepared a detailed Appendix illustrating that local exchange carriers now face real competition for their core lines of business, and that new competitors with significant resources and assets are entering into the provision of telephone services at a rapid rate, ensuring that LECs will face ever widening competition for their core lines of business.[108] Such data demonstrates how rapidly and fundamentally the competitive process is changing the complexion of the telecommunications market.[109]

The chief factoid quoted by several commenters to support their jaundiced view of competition is that 99 percent of local and/or access traffic traverses the LEC

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[107] See Comments of BellSouth at Attachments 2-4.

[108] Harris Report, Appendix B.

[109] The reality and speed of emerging competition in the local exchange, and the concomitant need for LEC regulatory reform to meet that competition, is reinforced by daily developments. Just yesterday, The Wall Street Journal reported that some 5.2 billion dollars of GTE's long-term debt was downgraded by Moody's, who cited "growing competitive and regulatory pressures" as the reason for the action. "GTE Corp.'s Rating Reduced by Moody's; $5.2 Billion is Affected," The Wall Street Journal (June 28, 1994), at C16.

network.[110] These market share estimates, however, distort any true description of current competitive environment and have no bearing on the rate at which competition will develop. Schmalensee and Taylor demonstrate the irrelevance of these market share numbers. They point out that the commenters ignore the specification of the appropriate economic product and geographic markets, and confuse measures of market share with measures of market power.[111] Indeed, none of the non-LECs' global market share estimates provides any information whatever concerning the LECs' ability to raise the price of any service in any market. They thus have no relevance in assessing the desirability of LEC pricing flexibility for interstate access services.[112]

Despite its apparent conversion in this proceeding to advocating the use of market share data as the measure of competition, AT&T has in the past recognized that market share alone does not indicate competitiveness. Indeed, less than a year ago, AT&T argued:

> The suggestion that AT&T's current market share may be indicative of market power is particularly inexplicable, in view of the Commission's prior recognition that an analysis based on market share "at a given point in time" is "too static and one dimensional," and that the decline in market share over time is far more probative....In all events, a substantial market share "is not incompatible with a highly competitive market," as the Commission has also recognized.[113]

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[110] Comments of MCI at 64-65; Comments of Teleport at 14-15; Comments of Ad Hoc, Attachment A at 100; Comments of AT&T at 9.

[111] See Richard Schmalansee and William Taylor, "Reply Comments: Market Analysis and Pricing Flexibility for Interstate Access Services" (June 29, 1994) ("Schmalansee and Taylor"), at 3 (attached to USTA Reply Comments).

[112] See id. at 10.

[113] Motion for Reclassification of American Telephone & Telegraph Company as a Nondominant Carrier, In the Matter of Policy and Rules concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefore, CC Docket No. 79-252 (filed September 2, 1993), at 15 n. 45.

Thus, the Commission's inquiry regarding competition does not end with a market share analysis as some parties would suggest.

Indeed, the data provided by BellSouth in its comments underscore the meaninglessness of broad market share estimates. The use of all-inclusive product and geographic markets, for example, overlooks the fact that BellSouth's access services are provided in highly concentrated markets.[114] BellSouth's submission demonstrated that in Florida, for instance, 60 percent of the BellSouth's access revenues come from less than 19 percent of its service area. In Tennessee, 30 percent of the access revenues come from 1.7 percent of BellSouth's service area.[115] These examples are not atypical.

Moreover, the reality of these revenue concentrations has not been lost on LEC competitors, who have deployed facilities in specific and limited geographic areas. BellSouth submitted examples of CAP networks that have been deployed in several cities served by BellSouth.[116] The information provided by BellSouth shows that CAPs are able to target specific high revenue customers with a very limited deployment of facilities. The revenue concentrations coupled with the fact that competitors are deploying networks precisely in those geographic areas presents a compelling case that any competitive analysis made by the Commission must occur on a narrow geographic basis.

Equally thin are calls for broad product markets. MFS and Teleport argue that the competitive analysis must include total local markets. In their view, because the LECs use common and shared facilities to provide all of their services, LECs have the ability to cross-subsidize and shift costs from competitive services to less competitive services.[117] These arguments are part of a prevailing theme that appears in several parties' comments,

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114/ See Comments of BellSouth, Attachment 2.

115/ Id.

116/ Id.

117/ Comments of MFS at 15-16; Comments of Teleport at 15-16.

namely, that the LEC price cap plan must feature a means of allocating costs and that the proper mechanism to do so amounts to a cost-based rate. BellSouth has already addressed the fallacy of such arguments.[118]

Beyond the incorrectness of using cost allocations for pricing purposes, however, the notion that there is cross-subsidy by or cost-shifting to less competitive services is fanciful. MFS and Teleport seem to imply that LECs are free to engage in cross-jurisdictional cost-shifting. The dual regulatory scheme of the Communications Act, however, delimits very clearly the regulatory boundaries of the state commissions and the FCC. There is no pricing action that the LECs can take within the interstate jurisdiction that can be offset in the intrastate jurisdiction. The state commissions preside over a closed intrastate system. Equally specious is the notion that the LECs can cross-subsidize even within interstate access. BellSouth has proposed that services become subject to streamlined regulation as they become subject to effective competition. Those services that do not meet the competitive criteria would remain under price cap regulation. Price cap regulation itself would prevent the adjustment of price cap service prices upward to subsidize competitive services.[119]

It is abundantly clear that the non-LEC parties have a uniform purpose -- to delay any consideration of relaxing LEC regulation. Thus, the market tests and other criteria for competitiveness advocated by parties like AT&T and MFS make local competition a precondition for the Commission to either consider either permitting interstate access competition or adjusting interstate regulation. This strategy affords LEC competitors

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118/ See supra at 12-14.

119/ The fact that entrants will have a harder time competing against lower LEC prices does not make those prices "unreasonably discriminatory," "predatory," or "unfairly exclusionary." It does mean, however, that competitors will have to compete on the merits rather than under a pricing umbrella. A price umbrella has the effect of taking money out of the consumer's pocket and putting it in the pocket of the competitor. No regulatory policy would justify subsidizing a competitor such as Time Warner or MCI.

numerous advantages. It maintains the yoke of regulation on the LECs for the maximum amount of time. More importantly, it builds in regulatory lag by necessitating future proceedings, yet, the lag which benefits the LEC competitors increase dramatically the costs to LECs and to consumers -- costs which increase exponentially as entry continues to occur and competition continues to increase.[120/]

BellSouth believes that the Commission can ill afford the consequences of failing to adopt a meaningful transition plan for competition in the interstate access market. Professor Harris, describing the reformation of railroad regulation policies, describes vividly the kinds of destructive consequences that can flow if an agency does not change its approaches in conformance with the changing market environment.[121/] The all-important lesson for the Commission is to decline the invitation of some parties to postpone adopting policies for the future.

BellSouth believes that the Commission can adopt a framework in this proceeding that will permit the Commission to identify services subject to effective competition and to streamline the regulation of those services accordingly. Indeed, in its comments, BellSouth described such a framework.[122/]

The Commission does not need to know how the future will unfold in order to establish the framework now. The framework enables the Commission to put in place the procedures to accommodate change. It does not prejudge a particular outcome nor does it grant any flexibility beyond that which market conditions justify.

Moreover, by adopting a framework that facilitates change and accommodates the future technological, competitive and market conditions, the Commission will be sending

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120/ Harris Reply Report at 3.

121/ See id. at 10 ("The final lesson from the rail experience is the importance of modifying policies before it is too late and thus, too costly.").

122/ See Comments of BellSouth at 93-95.

important signals to investors, entrepreneurs and customers about the direction of telecommunications policy.[123/] This is information that is essential to making planning decisions. It will bring an element of certainty to that planning process and as such will significantly contribute to the Commission's long term goals of infrastructure development. Adopting the appropriate transition framework now will be an affirmation of the Commission's commitment to encourage and reward innovation and efficiency.

IV. CONCLUSION

The Commission should adopt the recommendations set forth in BellSouth's Comments and these Replies.

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123/ The President's Council of Economic Advisors specifically identified provision of "a mechanism for removing existing regulatory restrictions as the development of competition makes them unnecessary" as one of three forces of regulatory reform likely to boost investment, jobs and economic growth. CEA Study at 1. In this context, the Council cites the results of a recent "Delphi survey" indicating that respondents believe that "business and regulatory barriers, not technology, are the most critical problems for the deployment of the necessary technologies." Id. at 5.